No. 10,644

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

LORIN A. CRANSON, *Appellant,* vs. THE UNITED STATES OF AMERICA, *Appellee.*	

APPELLANT'S PETITION FOR A REHEARING.

LEON DE FREMERY,
MORRISON, HOHFELD, FOERSTER,
SHUMAN & CLARK,
Crocker Building, San Francisco 4, California,
Attorneys for Appellant and Petitioner.

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APPELLANT'S PETITION FOR A REHEARING.

To the Honorable Curtis D. Wilbur, Presiding Judge, and to the Honorable Associate Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

Appellant respectfully petitions this Court for a rehearing in this case on the following grounds:

1. The Court erred in stating in its written opinion rendered herein on January 24, 1945, that there has been no showing that any of the loss sustained by Honolulu Oil Corporation, Ltd., upon the liquidation of its subsidiaries, was incurred in the tax year in question, namely 1936. *It is stipulated* (R. 33) *that the subsidiaries were liquidated on August 31, 1936, and that upon said liquidation Honolulu realized a loss of $1,225,908.63,* the entire amount of the loss in question. (Appellant's Opening Brief, p. 5.) As a result of

said misconception of the facts, the Court has dismissed without consideration appellant's alternative contention that the loss realized by Honolulu upon the liquidation of the subsidiaries reduced the earnings of Honolulu available for dividends.

2. The Court erred in stating that it is admitted that $931,553.82 earnings or profits were made in 1936 by the parent corporation. *It is stipulated* (R. 38) *that these are the earnings before deducting the loss of $1,225,908.63 realized in 1936 upon the liquidation of the subsidiaries.* Thus the *stipulated fact* is that Honolulu had no earnings available for dividends in 1936, but sustained a loss in the amount of $294,354.81, completely eliminating the earnings of $139,631.26 as of January 1, 1936. (See footnote p. 2 Appellant's Reply Brief.) Thus the actual fact is that the dividends are distributions of capital *and not income to the recipients.* The Court below, having held that appellant must pay an income tax upon a return of capital, and having so held because of the provisions of section 501 of the Second Revenue Act of 1940, has necessarily decided that this statutory provision is constitutional in its application to this particular situation. Whether the lower Court's application of this statute violates the provisions of the Sixteenth Amendment of the Constitution of the United States in so far as appellant and the other stockholders of Honolulu are concerned is a matter necessarily involved in this case and therefore before this Court for decision. Appellant also contends that the attempted retroactive application of this statutory provision for a period of more

than four years is a violation of the due process clause of the Fifth Amendment of the Constitution of the United States. The Court has failed to pass upon this question.

3. The Court has misapplied the cases of *Long Beach Improvement Company*, 5 B.T.A. 590, and *Foley Securities Corporation*, 38 B.T.A. 1036. These cases are cited in support of the proposition that if Honolulu itself had had an operating deficit at the beginning of 1936, the deficit could not have been deducted *in ascertaining the earnings available in 1936 for the payment of dividends.* The *Foley Securities* case stands for exactly the reverse of this proposition, the Court there holding that a deficit as of December 31, 1933, in the amount of $23,650.53 *must be deducted* from 1934 earnings in the amount of $49,909.52 in order to determine the earnings available for dividends in 1934. The Court there held that only the remainder in the amount of $26,258.99 was available for dividends.[1] The *Long Beach* case holds that a corporation *is subject to tax* on its net income for the taxable year although such income is not sufficient to wipe out a preexisting deficit. It is apparent from the citation of this case that the Court is confusing the statutory net income upon which Honolulu must pay a tax, with the earnings of Honolulu available for dividends. That this confusion exists seems apparent from the statement in the Court's opinion reading: "The equation of operating deficit for tax

[1]The statutory definition of dividend was changed, however, in 1936 to read as set forth in the Court's opinion so that this case is no longer in point.

purposes is the loss sustained within the taxable year." If appellant is correct in interpreting this sentence to mean that for tax purposes the loss sustained within the taxable year constitutes the operating deficit for that year, then the Court has failed to appreciate that operating deficit (or operating profit) need bear no relationship whatsoever to the loss as computed for tax purposes (or taxable income). (Appellant's Opening Brief, pp. 31-37.) Furthermore, in that event the Court has failed to answer appellant's contention that the *total* accumulated operating deficits of the subsidiaries reduced Honolulu's earnings (as distinguished from its taxable income) for 1936, the year in which it is contended the deficits were transferred to Honolulu upon the liquidation of its subsidiaries.[2]

4. The Court erred in assuming that it is necessary for appellant to prove what portion of the deficits of the subsidiaries occurred in the tax year 1936. It is obvious—in fact it is stipulated (R. 33)—that the loss of $1,225,908.63 actually realized by Honolulu upon the liquidation of the subsidiaries occurred and could only occur at the moment the subsidiaries were liquidated on August 31, 1936, at which time Honolulu received all the assets of the subsidiaries in exchange for all the stock of the subsidiaries. Honolulu's earnings for 1936 available for dividends were actually eliminated by this loss. (R. 38.) Since the loss realized on this exchange exceeded Honolulu's earnings avail-

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[2]That well-known text writers agree with appellant's position, that this Court has misconceived the question involved in this case, see Appendix "A".

able for dividends, the *excess* became an operating deficit of Honolulu, *and a 1936 operating deficit.* If this Court should hold that the principle of the *Sansome* case applies not only to inherited earnings, but also to inherited operating deficits, then it is equally obvious that this inheritance occurs and can only occur at the moment of liquidation. At that moment the entire accumulated operating deficits of the subsidiaries in the amount of $1,205,451.61 would be absorbed by Honolulu, with the result that the earnings available for dividends would be eliminated *in exactly the same manner as they actually were eliminated* by the loss sustained. Since these accumulated operating deficits exceeded Honolulu's earnings available for dividends, the *excess*[3] would become an operating deficit of Honolulu at that moment, *and necessarily a 1936 operating deficit of Honolulu.* Not only is this the obvious result; it is the only result which does not have absurd consequences. (See Appellant's Reply Brief, pp. 12-15.) It is therefore immaterial when the deficits were incurred by the subsidiaries. To consider this point material and to attribute the deficits of the subsidiaries to the parent corporation *for the years in which they were incurred by the subsidiaries* is to disregard the separate corporate entities of the subsidiaries during the years prior to the year of liquidation. (Appellant's Reply Brief, pp. 12-15.) Such a disregard of the separate corporate entities would be contrary to all the authorities.

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[3]The operating deficits *of the subsidiaries* do not as such become operating deficits *of Honolulu.* It is important to note that it is only the *excess* of such deficits over Honolulu's earnings which becomes an operating deficit *of Honolulu.*

Wherefore, appellant respectfully urges that a rehearing may be granted and that the mandate of this Court may be stayed pending the disposition of this petition.

Dated, San Francisco, California,
February 20, 1945.

Respectfully submitted,
LEON DE FREMERY,
MORRISON, HOHFELD, FOERSTER,
SHUMAN & CLARK,
Attorneys for Appellant and Petitioner.

CERTIFICATE OF COUNSEL.

I hereby certify that I am of counsel for appellant and petitioner in the above entitled action and that in my judgment the foregoing petition for rehearing is well founded and that it is not interposed for delay.

Dated, San Francisco, California,
February 20, 1945.

LEON DE FREMERY,
Of Counsel for Appellant and Petitioner.

(Appendix "A" Follows.)

Appendix "A"

Appendix "A"

Appellant has just now been informed that Volume 1 of the Cyclopedic Tax Service* which is now in the process of being reprinted contains a statement relating to the decision of the District Court in the instant case. Paragraph 105.30 of this publication is entitled "Effect of Transferred 'Earnings or Profits' of a Predecessor or Transferor Corporation". After setting forth the principle of inherited earnings and profits under the doctrine of the *Sansome* case and the various situations to which this principle has been applied the text contains the following statement:

> "* * * it would seem by parity of reasoning that operating deficits of the predecessors should decrease the earnings and profits of the successor. The only case on this point which has been discovered is an unreported decision in Lorin A. Cranson v. U.S. (USDC, Calif., 1943), now pending on appeal to the Ninth Circuit, wherein it was held that the operating losses of several subsidiaries absorbed by the parent in a non-recognized liquidation under the equivalent of I.R.C., Sec. 112 (b) (6), did not decrease the earnings and profits of the parent. The District Court cites no authorities and gives no reasons for this holding."

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*This is a recognized tax service of wide distribution published by the Coordinators' Corporation of Chicago. William KixMiller, President of Coordinators' Corporation, and Arnold R. Baar, Chief Legal and Editorial Adviser, have long been well known in the tax field. They were the founders and owners until recently of Commerce Clearing House whose Federal Income Tax Service was the first in the field and is one of the two leading services today.

Appellant has also been informed that at the time of the distribution of reprinted Volume 1 of this service it will be accompanied by an "As We Go To Press" section which will contain the following comment upon the affirmance of the District Court decision by this Court:

"§105.30. Effect of Transferred 'Earnings or Profits' of a Predecessor or Transferor Corporation.

Lorin A. Cranson v. U. S., ... F.(2d) ...... (CCA 9th, Jan. 24, 1945), aff'g USDC, Calif.

"Since a corporation inherits the earnings and profits of a predecessor corporation acquired upon a tax-free exchange, it should follow, as stated in the text, that an operating deficit should also be inherited so as to decrease the earnings and profits of the successor. The only case in point is the Cranson decision which has now been affirmed by the Ninth Circuit.

"As stated in the text, the lower court gave no reasons for its decision. The Appellate Court likewise gives no reasons, its opinion showing a complete misunderstanding of the issue. The opinion states:

" 'This is an open question. If Honolulu (the successor corporation) itself had at the begining of 1936 the same operating deficit, the deficit could not have been deducted. Long Beach Improvement Co. v. C.I.R., 5 BTA 590; Foley Securities Corporation v. C.I.R., 38 BTA 1036. An operating deficit is a bookkeeping convenience, which enables an individual to determine at a glance the present financial position of his business * * *'

"The two decisions cited by the Court (the only authorities referred to in the entire opinion) have no bearing on the problem involved. The Long Beach Improvement case holds, in the absence of a net operating loss carry-over provision in the law, that a corporation cannot deduct from its 1920 income a 1919 operating loss. The problem is not one of a deductible loss by the corporation, but of the amount of its accumulated earnings and profits available for dividends.

"The Foley Securities case, if relevant at all, is authority in favor of the taxpayer as it holds, for purposes of the dividends-paid credit of a personal holding company, that there can be no accumulated earnings and profits until an operating deficit is made good.

"As the Cranson decision is based upon a misapprehension of the problem involved, it cannot be considered a reliable precedent."